

# Privatization Policy in Serbia in 2003

(Policy Recommendations)

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Two years after the privatization law has come into force and the process was launched, privatization in Serbia has yet to yield anticipated results. Private property is still not prevalent; there is little evidence of substantial restructuring in corporate governance or of improved performance in privatized companies; and growth is still not picking up. By mid-June, 2003, 20 large firms have been sold (out of 200), and 545 smaller ones (out of 7,000). The revenue totals some \$525 million USD (\$229 in tenders, \$195 in auctions, and \$101 in the stock market exchange).

The complex reality of privatization mandates clean sales, competent and honest owners, and quick privatization. Unfortunately, all this cannot be accomplished at the same time, and some aspects of privatization have to be sacrificed. If one goal has to be traded off for another, experience teaches us that it is better to sacrifice some speed for improved quality. Effectiveness and legitimacy rather than speed of the process are in this paper taken to be essential for a successful privatization at this point. The paper sets out nine recommendations for a privatization policy that could make the privatization process more effective and legitimate.

## **1. The privatization policy model should not be changed or amended by other models that do not involve direct sale.**

- The existing privatization policy is based on the model of direct sale according to which up to 70% of the shares of a firm are sold either in tender or in public auction. This model has proven to yield best results in countries in transition in the last decade. It generates revenues for the government that can be used up for servicing foreign debt, reducing budget deficits, and building public sector institutions that will stimulate better corporate governance.
- The standard objection—that the direct sale model is flawed because “it cannot work without full-blown market institutions (wide openness of the market, developed financial market, and high level of competition), which still do not exist in Serbia”—is itself flawed. In Hungary and Estonia, where the model was applied, market institutions were weak and fragile in the beginning of the 90s. Yet these two countries are regarded today as successful privatization cases. In addition, more than 385 auctions carried out so far in Serbia have exhibited no grave market failures. Third, although it is true that the tender procedure is administered by the government (which diminishes the impact of market competition), that is simply the nature of the tender procedure, regardless of the environment in which it takes place. (Other problems related to the tender procedure are addressed in sections 2 and 8.)
- The argument that the market is necessary in order to carry out the direct sale privatization model points at the misunderstanding of the goals of a

privatization policy within the context of economic transformation. Privatization is meant to create market institutions. If Serbia was already a market economy, a comprehensive privatization program would not be required.

## **2. The agency of privatization should settle on the price as the key criterion by which it sells big enterprises in tender.**

- The Serbian government established four criteria that are decisive for tender sale of an enterprise: price, social program, future investments, and environmental program. The number of criteria brings about a number of problems. First, the method makes the comparison of the bids complicated, if not impossible. Second, the agency of privatization enjoys a discretionary right to decide which criterion is decisive for each particular sale. This discretionary right does not contribute to the transparency of the privatization process; it rather gives rise to the suspicion that corruption is possible. Selecting one single criterion by which the enterprises are sold beats off the objection that the process is non-transparent and corrupt.
- The price of the firm, not future investment or any other criterion should be the key criterion for sale. It goes against the logic of private property to oblige the bidder to invest in his own property. Additional social and environmental conditions essentially lower the price of the firm. Beside the fact that the conditions may never be fulfilled, they can potentially make a mockery of the sale. (In October 2002, to take one such example, three large sugar factories were sold for €3 each.) By insisting on more than one criterion, the government shows it wants to pursue manifold goals with one policy. The goal of the privatization policy is to sell enterprises. Other public policy goals are legitimate but they are best pursued by other policies (e.g. taxation, accounting legislation, environmental protection laws, etc.).
- To achieve this, it is not necessary to eliminate from the sale procedure all conditions that are not related to the price. It suffices to adopt minimal requirements that determine social program and future level of foreign investments that must be met by every bidder, and let the price affect the decision as to whom to sell the enterprise. (How such a sale could look like see in section 8.)

## **3. The pace of selling firms in tenders and in auctions, considering the circumstances, could speed up.**

- Excessively hasty pacing and sequencing may create social problems that could have adverse effects on privatization and the reforms. Successful privatization increases growth in the medium-term but always brings about job losses in the short-term. The government should take steps to ensure that workers, who unavoidably lose jobs, have a chance to find new jobs. This can be done by retraining programs, but much more effectively by higher levels of FDIs (see section 4).

- The agency of privatization could step up privatization of smaller firms, considering the fact that some 10% of the total number was privatized in this way. In many countries in transition small firms have been major investment and employment generators. However, it is quite possible that, considering the circumstances (shortage of investment capital in Serbia) and the capacity of the agency, the pace of auction sales has reached its peak. (How auction sales can be accelerated is discussed in section 6). Privatization of bigger firms should accelerate gradually in accordance with the opening of new jobs.
- One should not fear that faster privatization will exacerbate the situation on the labor market. Nowhere in East Central Europe has privatization led to social disaster. The unemployment rate in the Czech Republic in 1991 was 4.1%, and in 1998, 7.5%. In Hungary, in the same years, it was 7.4% and 7.8%, respectively. In 2000, Serbia had 12.6% and in 2002, the unemployment rate was 13.8%. The reason why larger social unrest did not occur was that the government did not act entirely in agreement with market principles in privatizing socially-owned firms. As long as this is the case with the Serbian privatization program, privatization can move faster.

#### **4. The government must intensify its efforts to remove obstacles for direct investments.**

- Privatization is not a panacea for a transitional economy. It sets the precondition for growth, but also implies layoffs, other forms of restructuring, and time-consuming changes in the way the economy functions. Privatization must be a part of a comprehensive program, the most important part of which is the attraction of FDI that builds new, competitive firms, and creates new jobs. FDI does not come into an environment in which there are too many obstacles. In Serbia, the obstacles are mainly of an administrative nature. The average time for registering a firm in the beginning of 2002 amounted to 50 days and cost €230 on average. Comparable costs are expected in terms of real estate, operating licenses, equipment, imports and transit of goods, commodity exports, certification of products and services, inspections etc. Such an environment is FDI-diverting, rather than FDI-attracting.
- On the other hand, the corporate tax rate also does not seem to be investment-attracting enough. Although Serbia has one of the lowest corporate tax rates in the region (14%), it still appears to be too high to attract the sought-for level of FDI. In 2002, FDI was mostly concentrated in trade, and not in production, which is why trade growth rate was 8.5%, whereas the industrial production growth rate was only 1.7%. In many countries—not only in those that employed the same method in privatizing—the government gave tax holidays for greenfield investment in the beginning of the transition. The same could be tried in Serbia.
- The removal of the administrative barriers is critical for starting up small and medium sized Serbian companies. The most important reason for the low level of investments for bigger foreign companies is most likely bound up with the

weak rule of law, macroeconomic imbalances and high risks (including political risks).

**5. The government should accelerate the building of other necessary market institutions (notably, the bankruptcy law and investment funds).**

- Serbia still does not have a complete bankruptcy law but only an insolvency law. This model of privatization dominated the Polish privatization program, Until March 1992, over 1,000 socially-owned firms went bankrupt, which enabled the creation of 545 new firms. The absence of the bankruptcy law enables firms to default on loans and get liquidated without the lender being compensated. The repercussions are dangerous:
  - Banks will not lend if they are not sure they can protect their assets; the shortage of investment and working capital does not contribute to the increase of growth;
  - The government will be under pressure to bail out companies when they default on loans, which imposes financial burden on the state budget;
  - The number of inefficient enterprises will not decrease, which causes their “healthy” assets to lie dormant.
- The investment funds law allows for the protection of smaller holders. There are lots of small stockholders who became stockholders under the 1997 privatization law. Besides, since the privatization program implies a free distribution of up to 30% of shares to insiders, there will be lots of small stockholders who will be created under the 2001 law. The example of the Apatin brewery shows how these smaller stockholders are unprotected, which undermines the belief of small holders that privatization pays off. Financial market institutions are necessary, for it is significant to enable small holders to trade their shares safely.
- The land registry is also one of the greatest problems in implementing the privatization program. It turned out that there are cases in which it is not possible to sell an enterprise because its company information is not entered in the land registry. The registry is a data base that serves as a basis for settling legal disputes between conflicting parties. For the solution of this problem, it is of paramount importance to amend the registry legislation.

**6. The agency of privatization has monopolized the privatization process. Its sway should be lessened, especially when it comes to the kickoff for the process.**

- The agency is in charge of “promoting, initiating, carrying out, and controlling the privatization process.” Although the privatization law (art. 16) postulates that privatization of a firm can be initiated by the firm itself, the ministry of privatization and the potential investor, in practice the agency appears to be the dominant agent in these matters.

- The agency cannot control itself. This should be done by the Council for fight against corruption, or some other special body established especially for this purpose.
- The privatization law should be amended to allow greater freedom to investors and firms to kick off privatization without the permission of the agency. The agency could retain the right to block the process if there is a reasonable doubt that crooks and drug-dealers intend to “privatize” a firm, but there should be some way for investors to initiate privatization.
- Article 61 of the privatization law by which local authorities get 5% of the revenue should also be amended. The proposed solution is that revenue can be higher (say, 8 or 10%) for every deal kicked off and completed by local authorities. This will increase the motivation of local authorities to look around for potential bidders and new owners.

**7. The government should work more closely with trade unions and the main political stakeholders in the country on implementing the privatization policy.**

- Successful privatization is not possible without public and political support. Public support implies that citizens (especially laid off workers) who stand to lose from privatization and economic reforms have the understanding that the process is necessary, and that they have the patience to hold out until they find another job. For this strategy to work, it is of paramount importance that the government and trade unions work together. The government must strive to reach a consensus on most important decisions, programs, or laws that relate to the losers in the transition.
- In order to strengthen consensus and reduce the social costs of privatization, the government should continue to compensate laid off workers with substantial compensation in terms of generous severance packages, low cost shares, or both. However, since these shares are only rarely going to be of high value in the short run, severance pay and unemployment insurance are likely to be of greatest compensation value.
- The government should abstain from excluding the main political factors from the policy process, for a tendency for arrogance and exclusion could be a double-edged sword in the near future. Serbia is still not a consolidated democracy. If they continue to be sidelined, such forces may attempt to significantly modify the privatization model if they get into the government after the next elections.
- The government does not seem too concerned with both matters. It often and unnecessarily frustrates trade unions by not listening to them in the Socio-economic Council. Privatization is a politically contentious and difficult policy in the best of circumstances. Governments that wish to implement privatization must do their best to build a broad political consensus on the basic objectives and procedures of the program.

**8. The work of the agency of privatization should be more transparent and under more effective parliamentary control.**

- The agency does not make public its criteria for including a firm in a tender. It also does not always publish the offers that were turned down, but only the offer that won. It is difficult for members of the public to obtain a copy of regular monthly reports the agency writes up for the ministry, and the six-month reports the ministry forwards to the Serbian parliament. Such information should be accessible to the public as much as possible. The agency should make public how the tender committee reaches the decision on whom to sell the firm to. It should publish all rejected offers. The reports should be easy accessible either on the Internet, or on personal demand.
- Since some business people may fear that exposing their losing bids to public scrutiny will give their competitors unfair advantage in how they value assets and business opportunities, the way to achieve this goal, while at the same time protecting confidential business practice, is to use a “two envelope” system—the first containing all the non-price criteria (e.g. investment and other commitments, or firm information required by the seller); the second containing a price only. The tender commission could examine the first envelope, determine which firms qualify, and then publicly (in Bolivia this was done on national TV) open the second envelope. The best price wins, and other prices are known.
- The privatization law mandates that the ministry of privatization forward to a parliamentary board a monthly report. The parliament is not required to discuss the reports, which is probably why no discussion on privatization has taken place in parliament since the adoption of the privatization law in June 2001. The minister should be obliged to address the parliament at least once a year, whereas the parliament should discuss its annual reports. Understandably, both things should be made public.
- Although in November 2002 the agency set up its web page where lots of useful data on enterprises under or prepared for sale can be found, the abovementioned reports and some rejected bids are still inaccessible. Changes to the law with respect to regular parliamentary hearings are not planned.